S&P Global Ratings

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Summary:

Sonoma Clean Power, California; Retail Electric

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ICR		
Long Term Rating	A/Stable	New

Rating Action

S&P Global Ratings assigned its 'A' issuer credit rating (ICR) to Sonoma Clean Power (SCP), Calif. The outlook is stable.

Credit overview

The ICR reflects the benefits of a growing, generally affluent, and highly residential customer base; robust liquidity; the absence of debt; and an overwhelmingly clean energy portfolio. Tempering these strengths are the ease with which customers can transition back to the incumbent utility and retail electric rates that are high relative to state averages but competitive with the incumbent investor-owned utility. Additional exposures include a budget that projects break-even operations, a portfolio of power purchase contracts with generally short durations, and power supply counterparties that include several companies that either exhibit weak credit quality or that we do not rate.

SCP is a joint powers authority and community choice aggregator (CCA). Since May 1, 2014, SCP has been procuring electricity for retail electric customers within 12 incorporated and unincorporated areas historically served by Pacific Gas & Electric Co. (PG&E). SCP serves 229,000 retail customers and derives 53% of its revenues from residential customers, 27% from small and medium commercial customers, and 17% from large commercial and industrial customers.

PG&E, on behalf of SCP, performs monthly retail electric meter readings, bills SCP's customers, collects customer payments, and conveys over its transmission and distribution system the electricity SCP procures. PG&E segregates and remits to SCP the revenues it collects for SCP; these revenues are insulated from a PG&E bankruptcy. If customers make partial bill payments, PG&E allocates shortfalls proportionally among PG&E and SCP. Shutoffs for nonpayment are exclusively within PG&E's control. Reserves for uncollectible accounts averaged 2% of operating revenues in the past five fiscal years, reflecting a generally prosperous service territory with pockets of lower-income customers.

Retail electricity customers who migrated to SCP at the introduction of SCP service in their area may return to PG&E upon 60 days' notice. SCP does not impose fees on departing customers. We consider the relative ease with which SCP customers can return to PG&E as a potential exposure to SCP's revenue stream. Yet, departures are few at a fraction of 1% per year since 2018. Departing customers might face PG&E fees when returning to PG&E. In addition, PG&E requires returning customers to subscribe to its bundled service for at least one year.

Representatives of SCP's member jurisdictions comprise the CCA's board. The board sets the retail rates for the power it procures. In addition to SCP's energy charges, the major components of the customer bills that PG&E prepares also include PG&E charges for energy delivery, SCP and PG&E administrative expenses, and PG&E's power charge indifference adjustment (PCIA). The PCIA is a legislatively created vehicle. It provides for PG&E's recovery of those portions of pre-existing generation investments and energy-procurement costs that market sales of energy surpluses created by customer migrations to CCAs do not financially support. The PCIA shields PG&E's non-CCA customers from the cost shifting that might otherwise occur due to the migration of retail customers to CCAs. The PCIA varies by customer class, but averages about 3.2 cents per kilowatt-hour, an amount that represents almost 14% of the average SCP customer all-in charge per kilowatt-hour, which diminishes SCP's relative competitiveness vis-a-vis PG&E and constrains the CCA's ratemaking flexibility.

The stable outlook reflects our assessment of strong customer retention rates; income levels within large portions of the service territory that mitigate high rates; robust liquidity that reduces but does not eliminate counterparty and customer migration risks; and a resource portfolio, that although of a significantly short duration, limits the utility's exposure to increasingly stringent emissions regulations and competitive and potentially volatile wholesale markets.

Environmental, social, and governance (ESG)

We believe that SCP faces limited environmental risks. Contracts for wind, solar, geothermal, and hydroelectric generation resources that are free of greenhouse gas emissions covered more than 90% of 2021's load and management projects similar coverage for 2022. Over the longer term, SCP's generation mix will depend on recontracting efforts and the availability of green resources.

Although direct wildfire liability risk is low because SCP outsourced transmission and distribution functions, public safety power shutoffs could nevertheless adversely affect the reliability of customers' electric service.

We associate moderate social risk with SCP's customer base. SCP derives about 85% of its revenues from customers within municipalities and unincorporated areas with household effective buying income levels (HHEBI) of at least 115% of national levels. The balance of the revenues come from customers within areas exhibiting significantly weaker HHEBI between 67%-88% of the national level. Although weighted-average retail rates were 5% below PG&E's in 2020, they were 124% of California's average retail system rate in 2020, which could weigh on financial flexibility, especially when considering lower-income customers.

We associate neutral governance attributes with management. Management has overseen more than 20% customer base growth over the past five years while securing a commensurate portfolio of clean energy resources and maintaining favorable financial performance. Yet, management's budgetary projections of financial performance contemplate break-even operations. Moreover, management opted to forego adjusting rates in 2021 to recover additional costs attributable to reduced hydrology and an increased exposure to elevated market energy prices. Management is relying on expectations of further revenue growth and some operating costs moderating as part of its plan for realigning revenues and expenses with historical levels. Management also anticipates PCIA reductions that could create capacity to raise rates without eroding competitiveness. When setting rates, management's goal is to perpetuate at least a 5% advantage relative to PG&E's bundled rate, while prioritizing the recovery of current year expense. SCP management does not adjust rates in lockstep with PG&E rate adjustments.

Stable Outlook

Downside scenario

We could lower the rating if SCP experiences customer defections at levels that leave it with meaningful surplus energy purchase commitments whose cost must be recovered either through rate increases or sales in competitive wholesale markets. We could also lower the rating if the cost of future power purchase arrangements negatively affects competitiveness, if SCP faces significant power supply counterparty nonperformance that erodes the CCA's liquidity reserves while simultaneously increasing dependence on wholesale market prices, or if SCP consistently produces break-even or close to break-even operations, as the budget contemplates.

Upside scenario

We do not expect to raise the rating in the next two years, given the inherent risks posed by direct competition for the retail customer base, already high electric rates, the CCA's several short-term power supply arrangements with counterparties exhibiting uneven credit attributes, and a budget that contemplates break-even operations.

Credit Opinion

Enterprise profile

SCP benefits from serving a growing and largely residential customer base with little exposure to industrial customers and no meaningful customer concentration. In addition, much of the large service territory exhibits above-average income levels, indicating the affordability of electric rates that are high relative to state averages. Yet, the uncollectible account reserve at 2%, while nominally low, suggests affordability issues might be present within lower-income portions of the service territory.

We believe that a power supply portfolio that is overwhelmingly concentrated in resources that do not produce greenhouse gas emissions positions the utility to meet increasingly stringent legislative and regulatory environmental initiatives.

Several factors temper SCP's enterprise strengths. Among them is the ease with which customers can revert to PG&E as their electric provider if SCP's relative competitiveness vis-a-vis PG&E declines. Additional exposures include the short tenor of many power supply arrangements, the risks inherent in counterparties that include suppliers that we believe exhibit weak credit attributes, and the affordability issues that might be present in portions of the service territory.

Financial profile

SCP does not have any debt and does not plan to issue debt. However, S&P Global Ratings calculates a fixed cost coverage (FCC) to reflect our view that SCP is funding its power suppliers' recovery of investments in generation capacity. Power purchase expenses represent about 90% of operating expenses, net of depreciation and amortization.

When calculating FCC, our proxy for suppliers' recovery of capital investment from their purchasers reduces operating expenses and imputes debt service by a matching amount. Applying that adjustment, we calculated accrual-basis FCC of 1.2x in 2018 and 2019, 1.0x in 2020, and 1.1x in 2021. Contributing to 2020's and 2021's weaker FCC are the years' diminished hydrology conditions, higher-than-budgeted market energy prices, and management's decision to forego a 2021 rate adjustment while awaiting additional revenues from customer base growth and expectations of lower operating costs. Management budgets for break-even operations.

We consider the $85 million of unrestricted cash and investments and rate stabilization funds that SCP reported at fiscal year-end June 30, 2021 as providing a robust cushion for tempering exposures to potential customer departures or supplier disruptions. With the rate stabilization fund, as of June 30, 2021, liquidity represented almost six months' operating expenses.

Related Research

- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.